

Dear Small Employer:

Although nearly 39 million Americans are covered by some form of employer-sponsored retirement plan, many people in the full-time work-force—about 50 percent—have no retirement coverage other than Social Security.

Private pension plans represent an attractive way of supplementing Social Security. They offer tax advantages to sponsoring employers and are important in attracting and retaining qualified employees.

Despite the incentives to support retirement plans, many small businesses do not provide workers with pensions. According to data analyzed by the U.S. Small Business Administration and the U.S. Department of Labor, fewer than one out of five individuals employed by firms with 25 workers or less are in businesses that have pension plans, as compared to five of every six workers in firms with over 500 employees.

The significantly lower rate of plan sponsorship among smaller businesses can be attributed in part to the complexity, administrative cost and paperwork associated with corporate retirement programs.

Simplified Employee Pensions, or SEPs, give employers an easy way of providing retirement income for themselves and their employees. Sponsors of SEPs can set aside as much as \$30,000 annually per participant with a minimum amount of complexity and paperwork.

This booklet is intended to provide helpful information about SEPs and to highlight their advantages. We hope it will encourage you to consider SEPs as a retirement savings vehicle.

Sincerely,



David M. Walker

Assistant Secretary
Pension and Welfare Benefits Administration
U.S. Department of Labor



Frank S. Swain

Chief Counsel for Advocacy
U.S. Small Business Administration



**Simplified
Employee
Pensions**

Introduction

Simplified Employee Pensions—known as SEPs—represent an easy low-cost retirement plan option for employers who do not have corporate plans. Employers who sponsor SEPs can—

- Make tax deductible contributions for themselves in any amount they choose up to \$30,000 annually;
- Omit contributions in years when contributions are unaffordable; and
- Avoid the administrative costs and most of the reporting requirements of corporate plans.

In addition, the Tax Reform Act of 1986 established a salary reduction feature for SEPs maintained by employers who have 25 or fewer employees. If certain tests are met, plan participants can make voluntary tax-deferred contributions to a SEP.

Whether a SEP is appropriate for your business will depend on factors such as revenue, firm size and the age, compensation and retirement needs of the business owner and work force. You may want to discuss other retirement plan options with an accountant, attorney or pension consultant.

WHAT ARE



SEPs are retirement programs established by you, as an employer, which allow you to provide retirement benefits for yourself and employees without paying the high start-up and operating costs of conventional plans.

Created by Congress in 1978, SEPs work on many of the same principles as Individual Retirement Accounts (IRAs): For example, contributions are made to individual accounts which are managed by financial institutions. The two critical differences between SEPs and IRAs are that:

- SEP contributions are generally made by employers, not employees; and
- The amounts contributed to SEPs can be much larger than the amounts contributed to IRAs.

As a general rule, up to 15% of each employee's pay—including your own—can be put into a SEP each year, for a maximum of \$30,000.

WHY SET UP

Advantages for you as an employer

- A SEP can provide a significant source of income at retirement.
- Contributions to a SEP are tax deductible and your business pays no taxes on the earnings of a SEP's investments.
- You are not locked into making contributions in future years. You can decide each year whether to pay into the SEP and how much to contribute.
- Once you put money into a SEP you have no further responsibility for the amounts contributed. The funds are managed by a financial institution.
- A SEP may be established and operated without the administrative expenses, consulting fees, or commissions usually associated with maintaining a retirement plan.
- You ordinarily do not have to file any documents with the government.
- If certain conditions are met, you and your employees can make pre-tax contributions of up to \$7,313 in 1988.*
- SEPs can be set up by self-employed persons, partnerships, and corporations, including S corporations.
- SEP contributions can be made up until the date your tax return is due, including any extensions.

* This amount is indexed for inflation each year.



Advantages for your employees

- The money you contribute to your employees' SEP accounts, as well as the investment earnings, belongs to them—even if they stop working for you.
- Employers' contributions to the SEP are not included in employees' income for income tax or Social Security tax purposes.
- Employees pay no taxes on the amounts in their SEP accounts until they start withdrawing the funds.
- Employees can change the financial institution where their SEP is invested.
- In case of death, the assets in a SEP will go to someone the employee has chosen.
- SEP contributions can continue until employees retire, but they must start withdrawing assets in a SEP when they reach age 70½.

ESTABLISHING A

You can set up a SEP in a matter of minutes by using the Internal Revenue Service's "Model SEP" agreement. All you have to do is:

- (1) Decide the percentage of pay you want to contribute to the SEP. A uniform percentage of pay must be contributed for each employee.
- (2) Fill out Internal Revenue Service Form 5305-SEP, a quarter-page form with six blank spaces. This form is not filed with the Internal Revenue Service.
- (3) Set up an IRA at a financial institution to receive your SEP contribution. Ask your employees to set up IRAs to receive the contributions you make for them.
- (4) Mail the SEP contributions to the financial institutions.
- (5) Give employees included in the SEP a completed copy of the Form 5305-SEP and the questions and answers on that form, as well as a statement of the amounts contributed to the employees' SEP accounts.

No other reporting or disclosure is required.

You *cannot* use the IRS "Model SEP" if you currently maintain any type of qualified retirement plan or have ever had a pension plan that promised to pay specific benefits at retirement—a "defined benefit" pension plan. You also cannot use the Model SEP if you have any eligible employees for whom accounts have not been established, if you have any leased employees, or if you are a member of an affiliated or commonly controlled group of employers unless all the eligible employees of the group participate in a SEP.



Although using the IRS Form 5305-SEP is an easy way to set up a SEP, you do not have to use this model agreement. Many financial institutions have their own SEP arrangements that have been approved by the Internal Revenue Service. In addition, employers may design their own SEP subject to IRS approval.

If you use a non-model SEP, the law permits you to "integrate" SEP contributions with the Social Security contributions you have made for your employees. This means that you can subtract from your contribution to each employee's account an amount corresponding to part of your Social Security contributions (without regard to Medicare) for that employee. However, the percentage of pay contributed to SEP accounts on earnings below the Social Security wage base must be at least half the percentage of pay contributed to the SEP accounts on earnings above the Social Security wage base.

NOTE: In an integrated SEP, if more than 60% of the SEP assets go to company officers or owners, you may be required to make a minimum non-integrated SEP contribution of up to 3% of pay for all non-key employees for the following year.

WHO MUST BE INCLUDED IN A



Generally, any employee who performs services for an employer, members of an affiliated service group, a controlled group of corporations, or trades or businesses under common control must be included in the SEP. However, there are five exceptions to this general rule. Employers may exclude from the SEP:

- Employees who have not worked for the company during three out of the last five years;
- Employees who earn less than \$313 in 1988;*
- Employees who have not reached age 21 during the calendar year for which contributions are made;
- Employees covered by a collective bargaining agreement, if retirement benefits were the subject of good faith bargaining; and
- Non-resident aliens.

* This amount is indexed for inflation each year.

SALARY REDUCTION SEPs

If you are a for-profit employer with 25 or fewer employees, you may be able to set up a SEP that is funded by tax-deferred employee contributions. You can establish a Salary Reduction SEP if at least half of your employees choose to make contributions. Employees are generally permitted to contribute up to 15% of pay or \$7,313 a year, whichever is less, to a Salary Reduction SEP. Company owners, officers, and certain highly-paid employees cannot contribute more than 125% of the average percentage of pay put into the Salary Reduction SEP by all other eligible employees. Employers must notify employees by March 15 if the employees' contributions for the preceding year exceed these limits.

A company can have both an employer-funded SEP and a Salary Reduction SEP. However, the total amount contributed for any employee each year cannot be more than 15% of pay or \$30,000.

The simplest way to set up a Salary Reduction SEP is to use Internal Revenue Service Form 5305A-SEP, the IRS model agreement. Employers using this model agreement may be required to supplement the contributions of lower-paid employees who choose not to put money into the Salary Reduction SEP or who contribute only small amounts. The required employer contributions can be made to the Salary Reduction SEP or to a separate employer-funded SEP.

The IRS Model Salary Reduction SEP generally cannot be used by companies ineligible to set up employer-funded Model SEPs (see page 6) or by companies consisting of only owners, officers, and certain highly-paid employees.



Financial institutions authorized to hold and invest SEP contributions include banks, savings and loan associations, insurance companies, certain regulated investment companies, federally insured credit unions and brokerage firms. SEP contributions can be put into stocks, mutual funds, money market funds, savings accounts and other similar types of investments.

You and your employees will receive a statement from the financial institutions investing your SEP contributions both at the time you make the first SEP contributions and once a year after that. Each institution must provide a plain-English explanation of any fees and commissions it imposes on SEP assets withdrawn before the expiration of a specified period of time.

COMMONLY ASKED QUESTIONS ABOUT SEPs

■ If a company maintains a SEP for its employees, can the employees also make contributions to Individual Retirement Accounts?

Yes. If the employees choose to do so, they may combine IRA and SEP contributions in one account. NOTE: IRA contributions of higher income employees may not be tax-deductible. See IRS Publication 590.

■ What if an employee eligible to participate in a SEP chooses not to participate?

An employer can set up an IRA for the employee at a financial institution and make the appropriate contribution.

■ Does the employer have to pay Social Security or federal unemployment compensation taxes on SEP contributions for employees?

■ Do employers in companies with salary reduction SEPs have to pay Social Security taxes on their employees' pre-tax contributions?

Yes. In addition, employees would have to pay their portion of Social Security taxes.

■ When are income taxes paid on money in a SEP account?

Income taxes are paid when money is withdrawn from a SEP account.

■ When can money be withdrawn from a SEP account?

1197

FOR MORE INFORMATION ABOUT



Call the nearest office of the Internal Revenue Service and ask for the latest Publication 590. Ask for Form 5305-SEP if you are interested in the IRS Model SEP or Form 5305A-SEP, for the Model Salary Reduction SEP. Both forms have questions and answers to help you understand how these SEPs work. For answers to technical questions and new requirements resulting from tax changes, you can call the Internal Revenue Service Employee Plans Division Taxpayer Assistance line at (202) 566-6783 weekdays between 2:00 and 4:00 p.m. Eastern time. This is not a toll free number.

For additional copies of this booklet, contact the U.S. Small Business Administration, Office of Advocacy, 1441 L Street, N.W., Washington, D.C. 20416 or the U.S. Department of Labor, Room N-5666, 200 Constitution Avenue, N.W., Washington, D.C. 20210.

Form **5305-SEP**

(Rev. January 1987)

Department of the Treasury
Internal Revenue Service

Simplified Employee Pension-Individual Retirement Accounts Contribution Agreement

(Under Section 408(k) of the Internal Revenue Code)

OMB No. 1545-0499
Expires 10-31-88

**Do NOT File with
Internal Revenue
Service**

(Business name—employer)

the Internal Revenue Code and the instructions to this form.

The employer agrees to provide for discretionary contributions in each calendar year to the Individual Retirement Accounts or Individual Retirement Annuities (IRA's) of all eligible employees who are at least _____ years old (not over 21 years old) (see instruction "Who May Participate") and worked in at least _____ years (not over 3 years) of the immediately preceding 5 years (see instruction "Who May Participate"). This ☐ includes ☐ does not include employees covered under a collective bargaining agreement and ☐ includes ☐ does not include employees whose total compensation during the year is less than \$300.

The employer agrees that contributions made on behalf of each eligible employee will:

- Be made only on the first \$200,000 of compensation (as adjusted per Code section 408(k)(3)(C)).
- Be made in an amount that is the same percentage of total compensation for every employee.
- Be limited to the smaller of \$30,000 (or if greater, $\frac{1}{4}$ of the dollar limitation in effect under section 415(b)(1)(A)) or 15% of compensation.
- Be paid to the employee's IRA trustee, custodian, or insurance company (for an annuity contract).

Signature of employer

By

Date